May 2021

Green Bonds

Our Approach for Investments

Definition and history of green bonds

Green bonds are generally considered to be fixed income instruments whose proceeds will be exclusively used to finance or refinance activities with clear environmental benefits. In 2014, the International Capital Markets Association (ICMA) established the Green Bond Principles (GBP); a voluntary set of guidelines for green bond issuance. These guidelines cover the use of proceeds, project evaluation and assessment, management of proceeds and reporting.

The European Investment Bank brought the first green bond to market in 2007 and issuance has grown rapidly since then. The global green bond market has grown from aggregate issuance US$3.5 billion in 2010 to $49.9 billion in 2015 and $305.3 billion in 2020.[1] Up until 2013, supranationals (such as the European Investment Bank) dominated issuance. Issuers from Europe and the United States dominated in 2014 and 2015, while issuances from emerging economies represented a significant portion of these instruments from 2016 onwards. In 2020, the largest international green bond market was the European, while the top three countries for issuance were Germany at $41.7 billion, France at $39.5 billion and the United States at $25.5 billion.

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What is ASI's view of Green Bonds?

In our view, green bonds are key enablers in the transition to a low carbon economy, helping to fund numerous activities that have positive environmental benefits. Allocating capital to improve the environment and mitigate climate change is positive in our view. However, as responsible investors, it is essential we take into account numerous factors in order to find the most attractive and high quality green bonds. We focus not just on how the bond's use of proceeds are spent, but also on the ESG credentials of the issuer itself.

What are the challenges associated with green bonds?

At Aberdeen Standards Investments, we have identified two main challenges to green bonds and for these reasons, we have developed an internally consistent green bond evaluation framework. This approach ensures a minimum level of consistency in our green bond evaluation and enables us to distinguish between stronger conviction/high quality green bonds versus controversial/ lower quality ones. This framework for assessing green bonds may be used in addition to our fundamental credit and ESG research of the issuer.

Challenges:

1. **Lack of standards**: With the proliferation of green bond issuance across markets, there is a need for standardisation of what is considered a "green" bond. The EU Taxonomy is, to a certain extent, aiming to address this issue by setting out clear definitions of what is an eligible green activity. In the meantime, standards still vary across regions. This can be confusing for investors and clients alike as it hinders the understanding of what their funds are being used for.
2. **Greenwashing**: 'Greenwashing' is to SRI financing as 'whitewashing' is to politics. For instance, use of proceeds may not have a clear and ambitious positive environmental benefit. Moreover, embarking on a green project is not enough to make a company sustainable. Investors need to take a holistic view of a company's behaviours. At ASI, we consider the issuance and the complexity around green accreditation in tandem with the ESG creditability of the issuer. For example, allocating capital to a project with excellent green credentials may not be appropriate if the issuer displays contrary practices throughout the rest of its organisation. It is also important to take a holistic view of the issuance. A hydroelectric dam may have strong green credentials; however, its social impacts could be detrimental due to the displacement of people and agricultural land.

[1] Bloomberg (2021) "Green bond Issuance by type", Bloomberg Professional. [Online]. Available at: Bloomberg Subscription Service (Accessed: 25 March 2021).

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What is ASI's approach to Green Bonds?

Green bonds are issued in exactly the same way as non-green bonds. We only own those which will deliver to our clients objectives, therefore the credit must offer an attractive opportunity. However for funds which explicitly invest in green bonds, both the credit and ESG credentials of the green bond must be attractive.

We principally agree with the goals and benefits of green bonds. Purchasing these bonds can support a company's ability to raise capital to fund projects with positive externalities such as tackling climate change.

We consider the following factors when analysing a green bond from an ESG perspective:

Step 1: Does the issuer meet minimum credit and ESG standards?

It is important that the credit profile of the issuer is attractive regardless of the supposed 'green' credentials of the bond. If the issuer is rated a sell by the Credit Analyst, it is unlikely that we would consider purchasing a green bond from that issuer and we would not pursue the issue in question any further through this framework. We take into account the ESG view of the issuer using our proprietary Fixed Income ESG Risk rating framework and our ESG House score to ensure that the issuer meets minimum standards. In addition, we conduct due diligence to ensure that the issuer is not subject to controversies and/or is not involved in activities deemed controversial (such as coal mining).

Step 2: What is the overall sustainability approach of the issuer?

We expect the issuer to demonstrate that green financing is part of its overall strategy and sustainability effort. The issuance of a green bond is not a substitute for a long term sustainability strategy. A key consideration is whether the company has ESG commitments and targets that aim to make the overall business 'greener'. The most credible issuers, who are leaders in this space, will have time-bound, science-based targets and produce detail on progress such as milestones and KPIs.

Step 3: Alignment with green bond standards

We look for alignment with at least one of any widely acceptable green bond frameworks. In particular, we look for clear disclosure of use of proceeds. In order to avoid greenwashing, the bond should be funding 'green' activities/projects with use of proceeds. Therefore all designated green projects should provide clear environmental benefits, which will be assessed and, where feasible, quantified by the issuer.

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We also seek to gain a comprehensive understanding of the management of proceeds and expect disclosure with regard to how unallocated net proceeds are managed, the type of instruments they are invested in, and the timescales for distribution. Unclear disclosure of management of proceeds may provide loopholes. For example, some issuers may hold unallocated proceeds in GHG-intensive or non-climate friendly instruments if the framework is weak.

Step 4: External review

To ensure that the green financing framework or bond issuance is credible, we expect an external review to have been carried out. This may include: Second-party opinion, verification, certification or a rating. Self-labelled bonds need further investigation. For example, some issuers may simply label their bond as a green bond without seeking any outside validation of this claim. In these instances, the issuer's credibility is undermined as there is no third party verification that the funds from the sale of the green bond were used for their intended purposes.

Step 5: Reporting

In order to understand the characteristics of potential green bond investments, we view pre-issuance reports as best practice. This report should be 3rd party verified and outline the processes established to ensure alignment of the bonds with internally recognised guidelines. We also expect issuers to annually report on the funded projects' environmental impact.

Step 6: Does that company meet 'Do No Significant Harm' criteria?

Finally, we ask ourselves whether it is reasonable to assume that the overall green project will result in net positive outcome from an environmental and social perspective. We expect issuers to clearly describe the process applied to identify and manage potentially material environmental and social risks associated with the project.

Conclusion

This framework ensures a minimum level of consistency in our green bond evaluation and enables us to distinguish between stronger conviction/high quality green bonds versus controversial/ lower quality ones. However it is important that the framework is considered as part of the overall credit and ESG evaluation process of the issuer and bond.

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